INVESTMENT POLICIES OF THE WESTERN BALKANS AS A FACTOR OF ECONOMIC DEVELOPMENT IN THE POST-CRISIS PERIOD

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ABSTRACT

For the transition countries of the Western Balkans, in conditions of insufficient domestic savings and narrowing opportunities for further borrowing from international financial institutions, the need for dynamic inflow of foreign direct investment becoming one of the key preconditions for their future economic development. The economic crisis has sharpened the competition in the international capital market and the situation is that a number of countries are competing in the global market. Under such conditions, only those countries that have attractive investment policies can pretend to serious capital inflows of foreign direct investment. Foreign direct investments are very important for countries of the Western Balkans as they enable rapid development of many fields, especially trade that brings tangible and intangible resources that also mobilize domestic factors. In this paper, the authors will attempt to estimate investment policies in the Western Balkans and the effects they have on their future economic development. It highlights those policies that have the most impact in attracting foreign investment, as well as the weaknesses of some policies applied by the economy. In the paper will be used correlation model between foreign direct investment and the measure of economic growth, using relevant foreign direct investment database. Based on the used research methodology and analysis of relevant investment policies of the Western Balkan countries, the paper will show that the Western Balkans countries need to create favorable business environment, regulate the problems of law enforcement, transparency, corruption and improve infrastructure in order to more effectively attract foreign direct investment.

1. INTRODUCTION

Foreign direct investment (FDI) is recognized as a key modality of economic development of underdeveloped countries. Positive effects of FDI on export, economic growth and creating of new jobs, as well as the fact that, besides transfer of capital, these inflows also lead to transfer of intangible resources, such as technology and know-how, give FDI advantages over other sources of growth. This particularly applies to the Western Balkan countries for which, in the circumstances of economic crisis, opportunities to rely on their own finance sources or borrowing from international financial institutions are considerably limited.

Situation is similar in other transitional countries. Hence there is a keen competition for attracting FDI in the global market and legal regulations are quite liberal in all countries

aspiring to be hosts of FDI inflows. When speaking of legal regulations, labour price, incentives for attracting FDI and the like, they are becoming more or less the same in most transitional economies. Therefore, in the future period the vital factors for attracting FDI will be macroeconomic stability and functioning of the legal system and institutions. Advantages of transitional countries for attracting FDI in relation to the countries which have already joined the EU are lower labour costs and government measures for boosting foreign investment. These measures typically include fiscal incentives, financial subsidies and building necessary infrastructure.

Whether foreign investors will invest in one country or not, depends on the level of its macroeconomic and political stability, its institutional development, market orientation and openness for foreign trade. Therefore, for Western Balkan countries to become an attractive destination for foreign investment, the preconditions are credible monetary and fiscal policies, creating favorable business environment with competitive local market and anti-monopoly regulations, transparent legal system, implementation of laws, protection of proprietary rights, reducing corruption, improving infrastructure and continuing efforts towards the European integrations.

2. LITERATURE REVIEW

Effects of FDI on gross domestic product (GDP) and imports are frequently analyzed. Much research has been published on this topic, so Yan (2011) showed on the example of Nepal that the relationship between FDI and GDP cannot be described as direct linear or log-linear relationship, but that analysis of impact must be based on the secondary analyses which separately cannot produce genuine insight into this relationship. However, the summarized results can provide appropriate picture of the interdependence of these variables.

Furthermore, in his paper Gligorić (2013) confirmed the high positive correlation between FDI levels *per capita* and the levels of foreign trade in CEE countries in the period from 1995 to 2003. In addition, results of the empirical analysis indicate that FDI inflows represent a possibility for developing countries to improve their exports structure. It is mentioned that certain CEE countries which were in the first phases of transition led by domestic demand and were manufacturing clothes and furniture recorded later a notable FDI inflow and the largest growth in exports of components and parts of higher value added for further production.

Shawa and Shen (2013) examine the impact of FDI and GDP on the export in Tanzania, in the period from 1980 to 2012. By applying the classical VAR model, they came to the conclusion that there is significant causal link between FDI and exports, whereas the causality between FDI and GDP is not found. This result shows that by attracting FDI it is possible to influence increase in exports, whereby it is mentioned that Tanzania is a developing country, which should be taken into consideration when interpreting these results.

Liu, Burridge and Sinclair (2002) examined on the example of China the relations between FDI, GDP and trade. They used multivariable VECM (*vector error correction model*) tests of causality. It proved that there are strong two-way causal links between FDI, GDP and exports, whereas the feedback causality from exports was much weaker.

Sandalcilar and Altiner (2012) examine the relationship between FDI and GDP in ECO region through panel analysis. They applied the unit root, co-integration and causality tests in case

of panel analysis and found, as a result, that the effects of FDI inflows on the economic growth cannot be ignored in the countries which got independence in the 1990s.

Mercan and Yergin (2013) conducted an empirical analysis of the effects of FDI, exports and economic growth on the example of Turkey in the period from 1991:Q4 to 2013:Q1. Their research showed that there is a notable positive impact of FDI and exports on GDP, while only FDI separately influence GDP much less than exports.

In the above examples, it can be seen that the variables were observed separately or within the panel. However, the results obtained are different. Thus, results of some papers showed that the variables had considerable effects on each other, whereas the results of some other researches did not show significant impact. If positive causality between these variables is established, it means that it is possible to influence the economic growth of a country or a region by improving investment policies.

3. FDI AS A FACTOR OF ECONOMIC DEVELOPMENT IN WESTERN BALKAN COUNTRIES

For small, open economies, without adequate sources of domestic savings, the importance of attracting FDI becomes one of key preconditions for future economic growth. This is particularly important for transitional countries of the Western Balkans which are aspiring to become members of the EU. Accession process itself brings additional costs of catching up, because these countries started the transition process relatively late, facing greater difficulties than successful transitional economies. Knowledge and technology transfer that occurs through investment processes is equally important as capital transfer.

Low rate of domestic (private) savings is indicated as a reason for low investment rates in these countries as they all record high current account deficits. Therefore, their need for attracting foreign investment is obvious as they have no chance for growth without investment. Another reason lies in the expectations that investors will increase average productivity of the economic activity, which will in turn boost new investment opportunities. Even in the countries which do not have the same levels of current account deficits, those with higher share of FDI will record higher investment rates.

Based on the conducted research, it can be concluded that there is a strong correlation between the pace of economic growth and FDI inflows. Mutual interdependence of the pace of economic growth and FDI inflows is reflected so that direct inflow of capital either stimulates economic growth and transformation or responds to the opportunities resulting from the economic growth and progress of transformation. Economic growth can come as a consequence of foreign investment through additional investment of funds or transfer of technology, managerial and organizational skills, as well as through better access to export markets. On the other hand, foreign investors respond positively to the consolidated market economy regulations and continuation of economic growth.

Effects of FDI can also result in increase in employment and exports. There are several empirical researches which prove the high positive correlation between the level of FDI *per capita* and the level of foreign exchange. In the observed region, as in all other parts worldwide, FDI inflows and foreign exchange are complementary. Furthermore, numerous researches show that inflows of foreign investment represent an opportunity for the developing countries to improve their exports structure.

The overall effects of FDI on the local economy and its potential for economic growth can vary, depending on the capability of local companies and economic policy measures of the FDI recipient country. If foreign investors invest in the markets with technologically and financially weak local companies and with possibilities for differentiation of products and achieving effects of the economies of scale, there is a very high likelihood that companies with foreign capital may create a monopoly. This may lead to creating dual economic structure where foreign-owned companies compete with small local firms, which considerably weakens the resilience of domestic economy to the market cycles and changes in foreign-owned companies.

If the country's economic authorities conduct the competition policy based on liberalization of external flows, efficient anti-monopoly legislation and reducing market entry barriers and if they take a strategic approach towards FDI which implies their sectoral targeting and limitation of their entry into certain sectors, then it may be expected that presence of foreign capital in the local market will have positive effects on local firms. Increased competitiveness of local firms means that technological gap between these companies and companies with foreign capital is closing, which may lead to reduction in demand for products of foreign-owned companies, thus increasing the motivations of these companies for technology transfer. Transfer of advanced technology offers a possibility for appearance of technological externalities. (Nedeljković, 2003, page 95).

Many research papers came to conclusion that FDI had a significant contribution to the economic growth of CEE transitional economies, much greater than in developed and developing countries. If we take a look at the graph on Figure 1 (right), it can be seen that much more foreign investment went to transitional countries in comparison to the Western Balkan countries. It results from certain features of transitional economies which are primarily manifested in an opportunity for increasing productivity at the beginning of transition (due to initial inefficiency of usage of resources) and in the fact that this region had fairly developed human capital, whereas managing the existing physical capital was initially poor. Through combined action, these two factors allowed foreign investors to achieve fast growth in productivity by implementing modern management, new production and new capital (Kovačević, 2004, pages 436-437). Figure 1 (left) shows how the trend of foreign investment inflows is decreasing due to the consequences of the global financial crisis. This is yet evidence that Western Balkan countries must constantly strive to improve their investment policies, because any external shock may largely disturb the positive trend of FDI inflow.
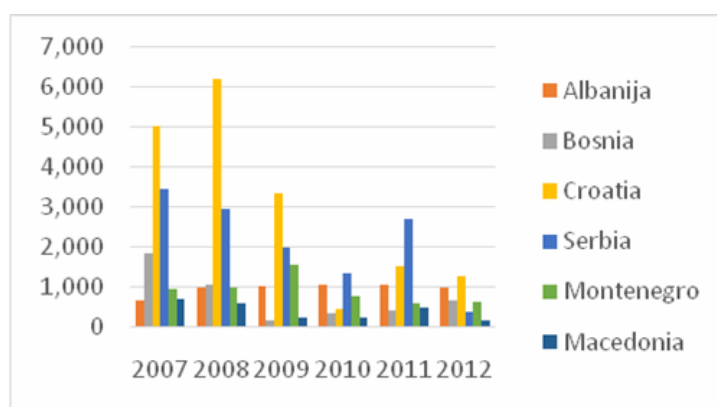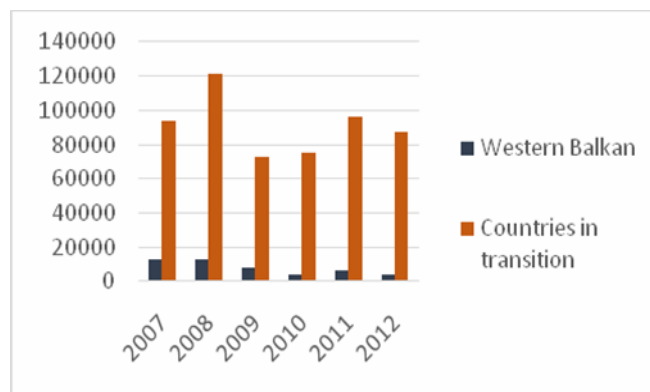

Figure 1. FDI inflow in the Western Balkan countries, in the period from 2007 to 2012

Source. The World Bank database 2013

According to last World Bank data projections (Vincelette, 2014), countries of Western Balkan have slow road to recovery. For future development these countries need to be driven by exports, need to have positive near-term outlook and need to provide macroeconomic stability and structural reforms. These elements together are key to sustaining growth of these countries. Recession in Western Balkans finally ended in 2013 on the back of the Euro Area recovery. Economies have recovered thanks to pick up in external demand, combined goods exports grew over 16 percent in 2013. Current account balances is narrowed. Exports strengthened and imports fell, contributing to trade rebalancing. External debt is remained high. Also, domestic demand was still very weak. Concerning labour market, outcomes are remained poor. Albeit falling, unemployment is still stubbornly high especially among vulnerable groups. However, for improvement of productivity and competitiveness for growth, these countries need to require structural reforms across the board – improve investment climate and labor market.

4. THE METHODOLOGY DESCRIPTION AND ACHIEVED RESULTS

Subject of the research in this paper is analysis of mutual correlation between FDI, GDP and exports in Western Balkan countries. The authors included the following six countries into Western Balkan countries: Serbia, Croatia, Montenegro, Bosnia, Macedonia and Albania. The observed time frame covers the period from 2002 to 2012. Values of these variables represent the summed up values for the above-mentioned countries, on annual level.

Examining the causal links was conducted by means of the basic econometric tools. The authors used the vector auto regression system (*VAR*) to explain the dynamic links among the observed three variables, through the following three steps.

The first step included examining stationarity of the time series. In other words, the authors checked whether each of the series separately has a unit root. The trend or stationarity shows that the series, observed in the long term, fluctuates around the line of deterministic trend or around its mean value, while non-stationarity means that the series tends to fluctuate far from the initial value with indefinite variance. Testing of stationarity is conducted by Dickey-Fuller test. Adequate null hypothesis claims that the series has a unit root.

If the above-mentioned test shows that series are of the same level of integration, long-term relationship of these series is checked. By testing the co-integration, it is established whether the linear combination of series with the same integration level is in the long run stationary. In such case the series are considered to be co-integrated. For those purposes, the authors used the Johansen Co-Integration Test.

As a final test, the authors applied the Granger Causality Test. This test provided information whether two or more variables mutually affect each other, whereby the test result shows whether such causality is unilateral or multilateral. When appropriate number of steps is chosen, the Granger Causality Test gives answer to the question whether by means of the previous values of one variable is possible to describe the other variable and vice versa or, respectively, whether the coefficients with previous values of the relevant variable are statistically significant. Null hypothesis of this test is that there is no Granger causality.

The first graph shows dynamics of movements of the three observed variables: GDP, FDI and exports for Western Balkan countries.

Graph 1: Dynamics of GDP, FDI and export in the Western Balkan countries, in the period 2002-2012
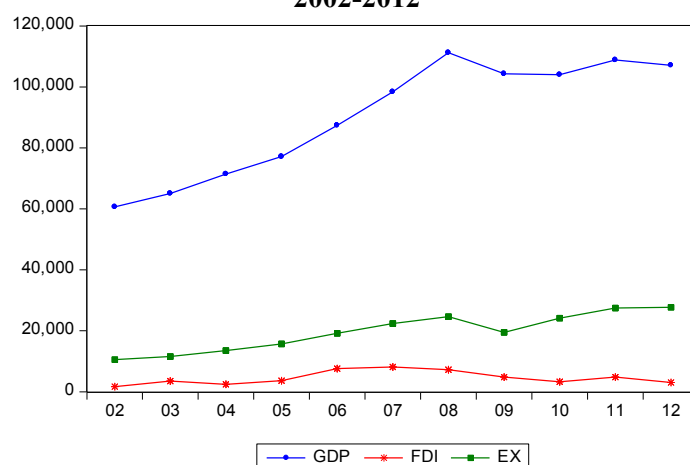
Source. UNCTAD database.

A large number of macroeconomic time series have unit root, that is, represent non-stationary series. It is for this reason that the authors used as the first test the Unit Root Test. At the same time, the order of integration of the observed series will be checked, which will be used later by the authors when checking the co-integration of the series. The result obtained through ADF test is given in the Table below.

Table 1. Stationarity (unit root) test (ADF)

Var	t-statistics			Critical value		
	At level	1st differences	2nd differences	1%	5%	10%
GDP	1.891242	-1.652937[*]	-3.601767[***]			
FDI	-0.457749	-2.522498[**]	-3.135757[***]	-2.847250	-1.988198	-1.600140
EX	1.531089	-2.502736[**]	-3.363157[***]			
Note: [*], [**], [***], denote rejection of unit root at the 10%, 5%, 1% levels of sign. respectively.						

Source. The results of author's research

Based on the results, the authors were able to conclude that none of the series is stationary at the level, while at the test significance threshold of 10% all series are stationary on the first differences. At the significance threshold of 1%, the hypothesis of presence of the unit root in other differences is rejected. Considering that for other series the hypothesis of unit root presence in the first differences can be rejected, the authors proceeded with the Johansen-Juselius Co-Integration Test.

Table 2. Johansen co-integration test

Series: GDP, FDI				
Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.
None	0.529183	9.767058	15.49471	0.2991
At most 1	0.282473	2.987508	3.841466	0.0839
Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 Critical Value	Prob.
None	0.529183	6.779550	14.26460	0.5515
At most 1	0.282473	2.987508	3.841466	0.0839
Note: Trace and Max-eigenvalue test indicates no cointegration at the 0.05 level				

Source. The results of author's research

The Co-Integration Test applied to the series of GDP and FDI showed, as a result, that there is no co-integration, that is, at the significance threshold of 5% both Trace and Max-Eigenvalue statistics reject presence of co-integration equation. Observing the FDI and EX series also shows that there is no co-integration.

Table 3. Johansen co-integration test

Series: FDI, EX				
Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.
None	0.385115	4.632836	15.49471	0.8465
At most 1	0.028039	0.255953	3.841466	0.6129
Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 Critical Value	Prob.
None	0.385115	4.376883	14.26460	0.8176
At most 1	0.028039	0.255953	3.841466	0.6129
Note: Trace and Max-eigenvalue test indicates no cointegration at the 0.05 level				

Source. The results of author's research

Table 3 contains results obtained for testing co-integration of GDP and EX variables. This case also shows that at the threshold of 5% the hypothesis of non-existence of the co-integration equation in either of the statistics cannot be rejected.

Table 4. Johansen co-integration test

Series: GDP, EX				
Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.
None	0.401948	5.831610	15.49471	0.7153
At most 1	0.125304	1.204907	3.841466	0.2723
Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 Critical Value	Prob.
None	0.401948	4.626703	14.26460	0.7880
At most 1	0.125304	1.204907	3.841466	0.2723
Note: Trace and Max-eigenvalue test indicates no cointegration at the 0.05 level				

Source. The results of author's research

While the co-integration test shows long-term equilibrium relationship, the Granger Causality Test identifies short-term equilibrium relationship. Considering that by Johansen Co-Integration Test the co-integration series for the analysis of Granger causality was rejected, the authors also used the unrestricted VAR model. An optimum step defined by the information criterion is equal to 1. Results of the Granger Causality Test are given in the Table below. Probability in Table 5 represents probabilities of rejecting the mentioned hypothesis.

Table 5. Granger causality test

Hypothesis	Prob.
FDI does not Granger cause GDP	0.0255
GDP does not Granger cause FDI	0.8426
FDI does not Granger cause EX	0.1299
EX does not Granger cause FDI	0.6776
GDP does not Granger cause EX	0.0145
EX does not Granger cause GDP	0.0530

Source. The results of author's research

The Granger Causality Test leads to a conclusion that there is a significant positive impact of FDI on GDP as well as the impact of GDP on exports. Effects of FDI on GDP prove the theoretical assumptions, which mean that it is possible through FDI inflow to influence a GDP growth. The authors have also observed that probability of rejecting the hypothesis that exports does not affect GDP is equal to 0.0530 (at the significance threshold of 10%), which proves the strong correlation between exports and GDP and vice versa.

5. INVESTMENT POLICIES OF WESTERN BALKAN COUNTRIES

Taking into consideration the above-proven positive effects of FDI on economic growth, the authors find that it is important to identify certain factors which cause that some countries

are more successful than others in attracting FDI and/or have better investment policies in comparison to other countries. These factors include the market size, its dynamics, openness and structure, costs of labour, energy and raw materials, as well as macroeconomic, institutional and political stability, foreign trade liberalization and membership in trade organizations, EU integration, subsidies for attracting FDI and quality of infrastructure. This paper will underline the advantages and disadvantages of the investment policies applied by the countries of the Western Balkans, as well as any unresolved questions in the investment environment.

Western Balkan economies largely use the incentives for attracting FDI. For instance, in Croatia, Macedonia, Montenegro and Serbia these incentives are non-discriminatory and made publicly available. Furthermore, many economies have signed a large number of international investment agreements. The main purpose of those agreements is to strengthen the credibility of these countries and to create a more favorable setting for attracting investors.

With regard to promotion and investment incentives, all economies have agencies for promotion of investment with the fixed annual budget and political support. However, capacities of some of these agencies need to be strengthened. This also means that it is necessary to establish a mechanism for monitoring and assessment of effectiveness of investment promotion agencies. The most developed system of the relationship of these agencies with clients was seen in Macedonia and Serbia.

Despite ongoing efforts to improve investment climate and business environment, Western Balkan countries still face certain constraints. Thus, for instance, Albania, Croatia, Montenegro and Serbia do not have the national requirement for board of directors and for temporary employment of management in foreign companies, while in Bosnia, Croatia, Macedonia and Montenegro there is concern about complicated administrative procedures for approval of temporary workers. In Croatia and Montenegro, the procedures for obtaining work visas and permits can be too long and include the obligation to meet with the relevant representatives of the authorities.

One of the major problems still faced by foreign companies is solving the question of ownership over industrial and residential land. There are also certain restrictions concerning purchase of agricultural land, as well as for purchase of real estate for non-EU member states. Ownership over the land is more limited in Albania where non-residents and non-resident legal entities may acquire state-owned non-agricultural land, provided, however, that the value of investment is three times higher than the value of the land. In Bosnia non-resident legal entities may not own certain resources, such as natural resources, although concessions are occasionally granted. In Croatia, foreign investors may not acquire agricultural and protected areas. In addition, there are rules that prohibit construction and commercial use in the coastal zone 70m off the coastline. In Macedonia, foreign residents may not acquire agricultural land although they may conclude long-term lease agreements under reciprocity principles and under the condition that the Ministry of Justice, in cooperation with the Ministry of Agriculture and Ministry of Finance, approves such lease. In Montenegro, there are also restrictions concerning the ownership acquisition of agricultural land and bordering zones, as well as forests and cultural heritage. In Serbia non-resident legal entities may not purchase agricultural land. Furthermore, there are restrictions for purchase of real estate, especially for citizens from non-EU member countries. For example,

in Croatia, acquisition of real estate by investors coming from non-EU member countries is allowed only upon approval of the Ministry of Justice and on the reciprocity basis. In Macedonia, citizens from the countries which are not EU and OECD members may own buildings, flats and business premises only upon reciprocity basis, according to the Law on Property and Other Real Rights.

Another big problem in these countries is registration of land, cadaster and restitution. Numerous reforms have been implemented in order to simplify the procedure of property registration. There are still, however, unresolved questions related to property rights in the region. Ownership over the land remains unclear in many economies. In Albania, ownership rights often overlap and the process of restitution is hindered due to illegal construction and corruption. In Macedonia, great efforts have been made to improve the land cadasters, but there are still inconsistencies.

In addition to the above, concerning the impact of certain factors on investment climate in Western Balkan countries, foreign investors gave the lowest mark to the mechanism for handling disputes between investors and state authorities, then information availability and availability of documentation, technical obstacles and shortcomings, certification, accreditation and harmonization, administrative hindrances for trade, human capital, access to financial resources, tax policy, as well as electric power and physical infrastructure.

Although all Western Balkan economies conducted reforms with a view to attract as much FDI as possible, weaknesses in the general business climate are still hindering investment flows.

6. CONCLUSION

Western Balkan economies have made considerable progress over the past years in developing open, transparent and predictable investment policies. Many economies signed a series of international investment agreements in order to ensure predictability and safety for investors. All economies have established investment promotion agencies with fixed annual budget and political support. Foreign investors actively participated in the process of privatization of companies in these countries; however, due to the onset of the economic crisis, most of these processes are stagnating or lagging behind. In the past few years, Western Balkan economies have achieved great progress in capacity building for implementation of tax policy, regular forecasts of aggregate tax revenues and supervision of public revenues and expenditures.

Although all Western Balkan economies carried out reforms in order to attract FDI, there are still weaknesses in the general business climate that are hindering investment flows. The obstacles for creating the competitive business environment in this region are corruption, insecurity and unpredictability of the legal and regulatory framework. In addition, a great problem lies in non-transparency and absence of necessary employment skills in these countries. Most companies find that available infrastructure in the region lacks competitive advantage. Furthermore, in terms of infrastructure quality, there are enormous differences in doing business in the major cities as compared to smaller towns outside the capitals.

Only those policies which are sustainable and which have long-lasting effects on the economy of a certain country contributed to the growth in FDI, whereas one-off incentives increased inflow of foreign investment only in the short run. To conclude, architects of investment policies in these countries should work on improving infrastructure, legislation, transparency, reducing bureaucracy and fighting corruption. It has been proved that the existing inflow of FDI in the observed countries was not sufficient to boost economy, solve economic problems and increase the living standard. For Western Balkan economies it is necessary to create more favorable business environment in order to ensure better positioning of these countries on the map of foreign investors.

By founding investment promotion agencies, all Western Balkan countries have institutionalized their aspirations towards attracting foreign investment. All the observed countries, except Croatia, have decided to attract foreign investment through tax incentives. Various measures and reforms have been undertaken in these economies in order to make business environment more attractive for foreign investors. The laws governing this area and intended for facilitating the procedures for investors, as well as protection of their rights have been adopted. On the other hand, the laws and regulations were not efficiently implemented. Western Balkan countries are still characterized by weak infrastructure, inefficient implementation of law, non-transparency and presence of corruption, which proved to be a considerable disadvantage of the region in the attempts to attract the limited investment resources and which will undeniably affect the sustainable economic development of these countries even after the global economic crisis.

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